THE ROLE OF TAX INCENTIVES

By Chris Micheli, David Doerr & Fred Main[1]

For a long time, the California Legislature has been struggling with the issue of whether tax incentives are effective. More recently, legislators have been examining methods of ensuring greater accountability with tax incentives. Some are pursuing a fundamental policy proposal that all tax incentive legislation contain a sunset clauses, measures to determine the effectiveness of tax incentives and public disclosure of taxpayer information.

While there are competing demands on state revenues, and there should be accountability in tax policy, a "one-size-fits-all" approach is poor tax policy. The California Legislature, where deemed appropriate, makes selective reporting requirements now. In fact, the business community supports such efforts on specific provisions.

We also need to be competitive with other states. While broad tax relief is always preferable, it is not always fiscally possible. Targeted tax incentives are less of a drain on the state's General Fund and they promote competitiveness with other states.

The business community does not object to periodic review of tax incentives. In fact, this already occurs. There is a regular Legislative Analyst's Office report on Tax Expenditure Programs. Also, the Franchise Tax Board provides an annual listing of all

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tax credits and the number of taxpayers claiming the credits, as well as the total amount of credits claimed.

Most of the tax law benefits have been provided to personal income taxpayers. The major tax breaks available to personal income taxpayers are:

- Home mortgage interest deduction ($3 billion)

- Employer contributions to employee pension plans ($2.6 billion)

- Dependent exemption credit ($1.3 billion)

The largest corporate tax incentive is the manufacturers' investment credit (MIC), which provides $365 million annually in tax relief.

EXAMINING EFFECTIVENESS

It is actually quite difficult to determine with great certainty the effectiveness of tax policy changes. Moreover, there are a number of concerns relating to making a determination of effectiveness and collecting the raw data to analyze to make such a determination. For example, who establishes the criteria? Are the criteria the same with all legislation? How is the data collected? How is the data evaluated?

In some cases, it will be necessary to actually contact the individual taxpayers and ask probative questions: "As a result of this change in the law, did you make additional purchases?" "Did you hire new people?" To what secondary level should we examine dynamic effects?

SUNSET DATES

One of the fundamental concerns of imposing sunset dates is that it is difficult for businesses to plan for the future. In fact, a sunset date can render a tax incentive meaningless when taxpayers, dealing with an early sunset date, will be loath to invest on a long-term basis. Such sunset dates simply allow the opponents of tax incentives to make the argument that the incentive will only benefit the businesses that were going to invest anyway.

As a result, the Legislature has wisely used this approach on a selective basis. Some measures that were subject to a sunset date but later made permanent include the research and development tax credit, as well as the treatment of employee stock ownership plan.

Provisions that automatically expired due to sunsets in California law and have not been reinstated include the tax credit for employer-subsidized transit passes, the Los Angeles Revitalization Zone (LARZ), and the credits for solar energy equipment and jobs.

SELECTED STUDIES

Despite protests from some groups opposed to corporate tax incentives, a number of such measures have been studied. For example, the research and development tax credit has been recently studied.

A 1998 study by Coopers & Lybrand found that, at the federal level, the R&D tax credit is such a powerful incentive that it will ultimately pay for itself due to its impact on productivity gains and economic growth, which thereby increase federal revenue.

GOOD TAX POLICY

Many opponents of tax relief simply “miss the boat” by arguing that all tax cuts must provide incentives. Changes in the tax laws are not always designed to provide an incentive to growth. They are also meant to underwrite the costs of socially desirable activities or to produce equity in tax statutes.

For example, while the MIC and R&D tax credits are meant to stimulate economic growth, the childcare credit is not. Certainly we are not trying to "incentivize" or encourage people to have additional children. Moreover, some proposed tax law changes are matters of tax equity, such as interest rate equalization, treatment of net operating losses, etc.

WORKER BENEFITS

Workers are benefiting by businesses being more competitive in the global marketplace. High-tech and biotech industries, in particular, are creating high-wage, high-skilled quality jobs for Californians. Good wages and benefits are needed for all California workers, but you cannot mandate those in exchange for tax cuts. Otherwise, there will be a disincentive to invest.

With a tight labor market, businesses are competing for fewer available workers. As a result, they are responding with more generous and more creative compensation packages for their employees.

BUSINESS TAX INCENTIVES WARRANTED

While California bank and corporation tax revenues have remained at about $5 billion annually for several years (due to a number of factors including the significant decline in the state's average corporate apportionment factors, as well as credits), it is these businesses that have created the record number of jobs over the past five years that has led to record employment levels.

Also, these businesses have provided generous stock options and market values that have made people wealthy, that have also increased personal income tax (PIT) revenues. Since 20% of PIT revenues are related to stock capital gains, California should want to ensure that companies continue to do well so that their stock values keep growing. The portion of capital gains receipts from sales of stock and the exercise of stock options is due to corporations performing well. This trend needs to be encouraged.

California must continue fostering a positive business climate. Employment levels in this state are at an all-time high with businesses hiring a record number of people. This business expansion has been fostered in part by tax incentives adopted in the 1990s.

California faces continued competition from other states. Others continue to entice California businesses with economic incentives to lower the cost of doing business in their states. To encourage a dynamic business climate, favorable tax policies need to be a part of the product mix.